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SENSITIVE

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TREASURY FOR OASIA - DAS LEE AND FPARODI
STATE PASS TO FED BOARD OF GOVERNORS FOR ROBITAILLE
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USDOC FOR 3134/ITA/USCS/OIO/WH/RD/DDEVITO/DANDERSON/EOL SON

E.O. 12958: N/A
TAGS: ECON EFIN ETRD PGOV EIND BR
SUBJECT: BRAZIL'S STEELY MONETARY POLICY

REF: A) 04 BRASILIA 3115
B) 04 BRASILIA 3100
C) BRASILIA 417
D) SAO PAULO 193

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¶1. (SBU) The GoB published a decree March 4 reducing to zero the import tariff on fifteen different categories of steel. The measure is temporary and does not represent a general liberalization, but rather is aimed at containing inflationary pressures driven by price increases in steel and other major industrial inputs. Dealing with these inflationary pressures has proven difficult for the GoB, despite the Central Bank's elevation of interest rates to 18.75%, in a cycle of monetary tightening beginning in September 2004. Despite the monetary tightening, and a concurrent 10% appreciation of the Real, inflationary expectations have hardly budged. This may be in part because current inflationary pressures, concentrated on the supply side, differ from previous episodes. The small percentage of credit in the economy, much of which is directed to certain sectors or loaned at fixed rates by the development bank, limits the influence of Central Bank interest rate changes on the course of the overall economy. The episode highlights the need for financial market reform and broader, permanent import liberalization to increase competition in the economy. End Summary.

Inflationary (and Political) Bias

¶2. (SBU) In December 8, 2004 conversation (ref A), Central Bank President Meirelles complained to the Ambassador about the inflationary bias in the Brazilian economy, and specifically about steel prices. Meirelles argued that this bias was a legacy of Brazil's hyper-inflationary past, when businesses tried to earn money by raising prices faster than wages could adjust. In January, President Lula echoed Meirelles' argument (made in private to the Ambassador), when he publicly criticized industry for increasing prices, blaming them for keeping inflationary expectations alive and forcing the Central Bank to raise interest rates higher than it would otherwise need. It was during that attack that Lula first publicly threatened to liberalize imports to restrain price increases. (Note: Brazil, while a major steel exporter, has imported between USD 456 million and USD 550 million worth of steel products annually over the last few years. End note.)

What has Inflation Been Doing?

¶3. (SBU) After spiking in 2002 due to the effects of currency devaluation, recently Brazilian inflation has been under control. The consumer price index (IPCA) peaked in 2002 at 12.5%, falling to 9.3% in 2003 and 7.6% in 2004. While not high in historical terms, this inflation has reacted stubbornly to Central Bank interest rate hikes meant to bring inflationary expectations in line with the 5.1% target for 2005. The Central Bank has raised its benchmark interest rate on overnight borrowing (the SELIC) by 2.75 percentage points, from 16% in September 2004 to the current 18.75%. Private sector inflationary expectations for 2005 (measured by Central Bank surveys of financial institutions that run their own forecasting models), however, have hovered in a band of about 5.7% to 5.95% during the period of adjustment. The Central Bank, for its part, has declined to revise upward its target, perhaps fearing -- as the local IMF ResRep recently confided to Emboffs -- that it needs to get inflation as low as possible this year as 2006 is an election year.

Is This Inflation Different?

¶4. (U) The interest rate hikes in particular have been

profoundly unpopular, and rekindled debate about the effectiveness of Brazil's inflation targeting regime and monetary policy tools (i.e. targeting inflation using the SELIC benchmark interest rate). Even some supporters of the inflation targeting regime and the GoB's orthodox policy line have begun to debate what lies behind the current inflationary stickiness and whether the SELIC is the right tool for achieving the target. For example, former Central Bank President Gustavo Franco has argued that recent inflationary pressure has been characterized by small supply shocks (such as the steel price increases that sparked Lula's and Meirelles' ire), the costs of dealing with exchange rate volatility and the high cost of credit itself.

Limits of Current Monetary Policy Tools

¶5. (U) In addition to the nature of the current inflationary pressures, several structural elements in the financial system tend to limit the effectiveness of Central Bank interest rate changes on overall economic activity. First, credit as a percent of the economy is low, at 26.3% of GDP in January 2005. This is down over ten percentage points over the last decade, albeit on a recent upward trend. Many businesses, particularly those that do not have access to lower interest rate foreign currency loans, tend to self-finance investment out of retained earnings.

¶6. (U) The amount of credit directly influenced by the SELIC is further reduced by the existence of "directed credit," which, according to Central Bank data, makes up about 36% of all credit. Over half of all directed credit is long term financing granted by the National Development Bank (BNDES) at a GoB-set rate (the TJLP, currently 9.75%), which does not reflect changes in market interest rates. The remainder of directed credit consists of agricultural credits (30%) and housing credits. These latter two categories of credit have below-market floating interest rates that track the overall direction of market interest rates. These directed credits are among the villains that account for Brazil's infamously high lending spreads.

¶7. (U) Other, likely less significant factors limiting the effectiveness of monetary policy are the effects of recent microeconomic reforms designed to enhance access to credit, including the 2003 creation of payroll-deduction loans. While payroll-deduction loans work to increase the aggregate amount of credit -- which, all things being equal, would tend to make interest rate targeting more effective -- like BNDES lending, these particular loans have commanded far lower interest rates than normal personal loans. A similar measure that would use social security pension benefits to secure loan repayments is under implementation. Franco further pointed out that Brazilian consumers, in particular, have become so inured to scandalous interest rates that a change of only a couple points has very limited impact on consumption decisions. Taken together, these factors reduce the impact that the price of overnight credit, embodied in the SELIC, has on much of the economy.

Need More Competition

¶8. (U) One factor that the public debate has not focused on is the existence of cartels in many sectors of the economy, making prices stickier (ref D). While the GoB is cognizant of the existence of such, and domestic air carriers (traditionally one of the economy's high tariff sectors) have recently launched a price war, the government's plans to improve competition policy and anti-monopoly efforts are longer term (septel). Thus the decision to liberalize steel imports, in an attempt to boost competition and reduce prices in a more relevant timeframe. Industry reaction has been mixed, with car manufacturers and other steel consumers welcoming the opportunity to negotiate with foreign suppliers as leverage in price negotiations with domestic steel suppliers, while the steel industry predictably has dissented.

Comment

¶9. (SBU) Despite the debate over the effectiveness of the SELIC and, secondarily, the inflation-targeting regime itself, the GoB does not intend to abandon either. Moreover, attitudes in the financial markets may be catching up those in the Central Bank. The IMF Resident Representative observed to Econoffs March 8 that over the last month financial market participants have begun revising their views that the Central Bank would be forced to abandon the 5.1% inflation target for the year as unrealistic. That said, the episode highlights the

importance of further microeconomic reform of the financial system, particularly to eliminate directed credits and to make BNDES interest rates more closely reflect monetary policy objectives. While some financial system reforms, such as measures enhancing access to credit, may work against the effectiveness of the SELIC in the short term, over the medium and longer term they should help create a more rational financial system, and one that ultimately will respond more readily to smaller interest rate changes by the Central Bank. Import liberalization, however welcome, will not contribute much towards that goal until it becomes broader-based and is made permanent.

DANILOVICH